

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Nakanishi Analyst: Raul Guzman Bill Number: AB 2737
Related Bills: See Legislative History Telephone: 845-4624 Introduced Date: February 24, 2006
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Employer Provided Qualified Health Insurance Credit

SUMMARY

This bill would create a tax credit for taxpayers that provide qualified health insurance for their employees.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to increase the number of people in this state that have health insurance.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2007, and before January 1, 2012.

POSITION

Pending.

ANALYSISFEDERAL/STATE LAWFEDERAL LAW**Employer deductions**

Existing federal law allows ordinary and necessary business expenses to be deducted, including health care coverage premiums paid by an employer for accident or health plans for employees.

Existing federal law also allows self-employed persons to deduct from gross income 100% of amounts paid for health insurance for themselves, spouses, and dependents.

Board Position:

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Department Director

Date

S. Stanislaus

5/3/06

Employee exclusion from gross income

Under federal law, a health savings account (HSA) means a trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary. HSAs are available to individuals who are covered under a high deductible health plan (HDHP) and are not covered under any other health plan which is not a high deductible plan. The amount of an employer's contribution including salary reduction contribution made through a cafeteria plan, to an accident or health plan for the benefit of an employee, or the employee's spouse or dependents is excluded from the employee's gross income.

Under federal law, a HDHP for 2004 means a health plan with an annual deductible of at least \$1,000 for individual coverage (\$2,000 for family coverage) and maximum out-of-pocket expenses of \$5,000 for individual coverage (\$10,200 for family coverage).

CALIFORNIA LAW

Employer deductions

California law conforms to the federal rules relating to ordinary and necessary expenses deductions and the self-employed health insurance deduction.

Employee exclusion from gross income

California has not conformed to any of the federal HSA provisions. The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. Adjustments relating to HSAs are required under current law, as follows:

- A taxpayer taking an HSA deduction on the federal personal income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Any contribution to an HSA, including salary reduction contributions made through a cafeteria plan, made on the employee's behalf by their employer is added to AGI on the employee's California return.

Existing federal and state laws provide various tax credits designed to provide tax relief to taxpayers that incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). Current state laws do not provide tax credits for any health care costs.

THIS BILL

This bill would allow a 15% credit for amounts paid or incurred during the taxable year by a taxpayer that provides qualified health insurance for its employees. The credit would be available for taxable years beginning on or after January 1, 2007, and before January 1, 2012.

“Qualified health insurance” would mean:

- amounts paid on behalf of employees to a high deductible health plan, or
- a health savings account.

“Qualified taxpayer” would mean:

- any new small to medium size employer, or
- any small to medium size employer that has not provided health insurance to their employees during the past five taxable years.

“Small employer” would mean:

- a person as defined in Section 7701(a) of the Internal Revenue Code, or
- a public or private entity employing at least 2 but not more than 19 persons.

“Medium employer” would mean:

- a person as defined in Section 7701(a) of the Internal Revenue Code, or
- a public or private entity employing at least 20 but not more than 199 persons.

This bill specifies the following:

- No deduction would be allowed for the same expenses for which the credit was allowed.
- Unused credits can be carried over to future years until the credit is exhausted.
- On or before September 1, 2010, the Franchise Tax Board provides a report on the usage of this credit to the Legislature.
- On or before March 1, 2011, the Legislative Analyst provides a report on the effectiveness of the tax credit to the Legislature.

This bill would allow the credit to Personal Income Tax Law (PITL) taxpayers, and Corporate Tax Law (CTL) taxpayers.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

This bill would allow the credit to “public entities.” Because a public entity is not a taxpayer, it is suggested that public entities could be removed from the language

This bill specifies that FTB is to provide a report to the Legislature on or before September 1, 2010, on the usage of this credit, but is silent on the specific information that should be included in the report.

Many businesses have employees in more than one state. Currently this bill would allow a credit for health insurance costs for employees that are employed by the taxpayer regardless of where they are located. The author’s staff expressed intent to limit health insurance costs to California employees. The author’s staff also expressed that this bill would be amended to reflect such intent.

LEGISLATIVE HISTORY

SB 1639 (Dutton, 2005/2006) would create a tax credit for small employers that provide health coverage to their employees. This bill was introduced February 24, 2006.

SB 195 (Maldonado, 2005/2006) would create a tax credit for small employers that provide health coverage to their employees. This bill failed to pass out of the house of origin.

AB 1262 (Campbell), AB 1734 (Thomson), and AB 2765 (Knox), from the 1999/2000 legislative sessions, AB 694 (Corbett) and AB 39 (Thomson/Campbell) from the 2001/2002 sessions were introduced creating an employer provided health insurance type credit. These bills failed passage in the Assembly.

SB 2260 (Stats. 1988, Ch. 1521) would have provided a small-employer health coverage tax credit; however, that credit was repealed before becoming operative.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. None of these states provide a credit comparable to the credit this bill would allow.

FISCAL IMPACT

Implementing this bill would require the creation of a new tax form, some changes to existing tax forms and instructions, and some changes to the department's information systems. All of these changes could be accomplished during the department's normal annual update.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

Revenue Impact of AB 2737 Enactment Assumed After June 30, 2006 (in Millions)			
	2006-7	2007-8	2008-9
Revenue Impact	-\$5	-\$25	-\$40

This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The assumptions and parameters embodied in the estimates are based on state employment data, discussions with industry experts, and a survey of literature related to the California health care industry.

Using Employment Development Department data, it was projected that 1,750,000 employees would be working in qualified taxable small businesses in 2007. Based on industry surveys, it was assumed that 10%, or 175,000, of these employees would receive insurance due to the incentive effect of this proposal.

The average monthly premium cost for Health Maintenance Organizations for 2004 was approximately \$260. The average premium for HDHP's was assumed to be about half of this amount or \$130 per month. A 10% annual growth rate was assumed for the premiums. This resulted in an estimated annual premium of about \$2,000 for 2007 ($\$130 \text{ per month} \times 12 \text{ months} \times \text{growth factor of 33 percent for three years from 2004 to 2007}$).

Employers' share of the insurance costs was assumed to be 85%, or \$1,700 ($\$2,000 \times 85\% = \$1,700$). The total qualified employers' cost for 2007 was projected to be \$298 million ($\$1,700 \times 175,000 \text{ employees}$). With a credit rate of 15%, this would yield total credit amount of \$45 million ($\$298 \text{ million} \times 15\% = 44.7 \text{ million}$). It was projected that only 55% of the credits would be used due to sufficient tax liability. Unused credits would be carried over for six years or until exhausted.

LEGAL IMPACT

If this bill requires taxpayers to provide health insurance to employees located within or residents of California in order for costs to qualify for this credit, the credit may be subject to constitutional challenge. The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. This case is now pending with the U.S. Supreme Court. The Court will issue its decision on this case by the end of June, 2006. Although the outcome of this decision and its affects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

POLICY CONCERNS

This bill leaves the number of years for the carryover period unlimited. Consequently, the department would be required to retain the carryover on the tax forms indefinitely. Recent credits have been enacted with a carryover period limit since experience shows credits are typically exhausted within eight years of being earned.

LEGISLATIVE STAFF CONTACT

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